

ORIGINAL



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MEMORANDUM

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TO: Docket Control

FROM: Ernest Johnson
Director
Utilities Division

DATE: November 7, 2005

RE: STAFF REPORT FOR VALENICA WATER COMPANY, INC.'S, APPLICATION
FOR AUTHORITY TO ISSUE DEBT (DOCKET NO. W-01212A-05-0606)

Attached is the Staff Report for Valencia Water Company, Inc.'s application for authority to issue debt. Staff recommends approval.

EGJ:CSB:rdp

Originator: Crystal S. Brown

Attachment: Original and thirteen copies

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AZ CORP COMMISSION
DOCUMENT CONTROL

Service List for: Valencia Water Company
Docket No. W-01212A-05-0606

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

VALENCIA WATER COMPANY, INC.

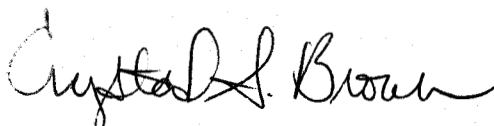
DOCKET NO. W-01212A-05-0606

**APPLICATION
FOR AUTHORITY
TO ISSUE DEBT**

NOVEMBER 2005

STAFF ACKNOWLEDGMENT

The Staff Report for Valencia Water Company, Inc., Docket Number W-01212A-05-0606, was the responsibility of the Staff members listed below. Crystal S. Brown was responsible for the financial review and analysis. Marlin Scott, Jr. was responsible for the engineering and technical analysis.



Crystal S. Brown
Public Utilities Analyst V



Marlin Scott, Jr.
Utilities Engineer

**EXECUTIVE SUMMARY
VALENCIA WATER COMPANY, INC.
DOCKET NO. W-01212A-05-0606**

Valencia Water Company, Inc. requests authority to issue long-term debt to the Water Infrastructure Financing Authority ("WIFA") in an amount not to exceed \$2,831,000.

The purpose of the financing is to provide funds for arsenic removal water treatment plant located in Arizona.

Staff recommends approval of the Company's application for authorization to issue long-term debt to the WIFA in an amount not to exceed \$2,831,000 subject to the following condition:

Until equity represents 40 percent of total capital, the Company is prohibited from distributing more than 25 percent of each year's earnings and is further prohibited from distributing any assets to principals via salaries, management fees, or otherwise in excess of current levels adjusted for changes in the Consumer Price Index.

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Introduction and Background

On August 24, 2005, Valencia Water Company, Inc. ("Valencia" or "Company") filed an application with the Arizona Corporation Commission ("Commission") requesting authorization to issue debt to the Water Infrastructure Financing Authority ("WIFA") in an amount not to exceed \$2,831,000.

Valencia plans to use the loan proceeds to finance water treatment plant needed to comply with the United States Environmental Protection Agency's ("EPA") revised drinking water standard for arsenic. The new standard that becomes effective January 23, 2006, reduces the maximum contaminant level from the current 50 parts per billion to 10 parts per billion.

Valencia is an Arizona Corporation located in the vicinity of Buckeye, Maricopa County, Arizona. Valencia charges rates approved in Decision No. 60832, dated April 30, 1998. As of December 31, 2004, Valencia provided water service to approximately 1,900 customers.

Public Notice

On October 19, 2005, the Company filed an affidavit of publication verifying public notice of its financing application. The Company published notice of its financing application in *West Valley View* newspaper of general circulation in Avondale, Buckeye, Goodyear, Litchfield Park and Tolleson, Maricopa County, Arizona on October 18, 2005. Attached is the affidavit of publication.

Purpose and Terms of the Proposed Financing

The purpose of the financing is to provide funds for construction of a water treatment plant to remove arsenic. Staff examined the construction plans and estimated costs for Valencia's water treatment project and found them to be reasonable and appropriate as discussed in the attached Engineering Memorandum. The proposed financing is a 20-year amortizing loan at a 5.85 percent interest rate.

Financial Analysis

Valencia provided financial statements for the 12 months ended December 31, 2004, in its application. However, those financial statements do not provide an accurate representation of on-going operating results because Valencia's customers have since increased by more than half from approximately 1,900 to almost 3,000. Valencia subsequently provided updated information projecting operating results for the 12 months ending December 31, 2005. The updated information consisted of actual financial results through the end of August 2005, projections for the last four months of 2005 and estimated operating expenses related to the proposed plant

additions. Staff reviewed and tested¹, the Company's projections and proforma adjustments. Staff accepted only the Company's projections that pertain to operation of the arsenic treatment plant for its analysis.

Staff's analysis is based on Valencia's projected financial statements for the period ending December 31, 2005. The financial analysis shown on Schedule CSB-1 presents selected financial information from the financial statements and the pro forma effect of the \$2.8 million loan. Schedule CSB-1 also shows the capital structure and ratios for debt service coverage ("DSC") and times interest earned ("TIER").

Capital Structure

At December 31, 2005, Valencia's capital structure is projected to consist of 1.53 percent short-term debt, 13.30 percent long-term debt, and 85.17 percent equity. Valencia drawing the entire proposed loan of \$2,831,000 would result in a pro forma capital structure comprised of 2.17 percent short-term debt, 68.88 percent long-term debt and 28.95 percent equity as shown on Schedule CSB-1.

Interest and Debt Service Coverage

Staff also examined the effects of the proposed financing on the Company's TIER and DSC.

DSC represents the number of times internally generated cash (i.e., earnings before interest, income tax, depreciation and amortization expenses) covers required principle and interest payments on debt. A DSC greater than 1.0 means operating cash flow is sufficient to cover debt obligations.

TIER represents the number of times earnings before income tax expense covers interest expense on debt. A TIER greater than 1.0 means that operating income is greater than interest expense. A TIER less than 1.0 is not sustainable in the long term but does not necessarily mean that debt obligations cannot be met in the short term.

Based on the projected 2005 financial statements before issuance of any new debt, Valencia's TIER is 25.78 and its DSC is 13.88. Fully drawing the proposed \$2,831,000 loan reduces the proforma TIER and DSC to 1.53 and 1.79, respectively. The pro forma TIER and DSC show that Valencia would have adequate cash flow to meet all obligations on the proposed debt².

¹ Staff compared the Company's projected September 2005 revenue (i.e., \$110,000) to its actual revenue (i.e., \$157,000) and concluded that the Company's revenue projections are not overstated.

² Calculation reflects the current interest rate of 6.56 percent on the proposed loan.

WIFA interest rate calculation for this loan: $(\text{Prime Rate} + 2\%) \times \text{Subsidy Rate} = (6.75\% + 2\%) \times .75 = 6.56\%$

Conclusions and Recommendations

Staff concludes that the project the Company proposes to construct is reasonable and appropriate.

Staff concludes that that Valencia would have adequate cash flow to meet all obligations on the proposed \$2,831,000 debt.

Staff concludes that the capital structure that would result from incurrence of the \$2,831,000 proposed debt is acceptable in the short-term but outside the desirable range for the long-term.

Staff concludes that the proposed financing is for lawful purposes, within Valencia's powers as a corporation, compatible with the public interest, consistent with sound financial practices and will not impair its ability to provide public service.

Staff recommends approval of the Company's application for authorization to issue long-term debt to the Water Infrastructure Financing Authority ("WIFA") in an amount not to exceed \$2,831,000 subject to the following condition:

Until equity represents 40 percent of total capital, the Company is prohibited from distributing more than 25 percent of each year's earnings and is further prohibited from distributing any assets to principals via salaries, management fees, or otherwise in excess of current levels adjusted for changes in the Consumer Price Index.

FINANCIAL ANALYSIS

Selected Financial Information
Pro forma Includes Immediate Effects of the Proposed Long-term Debt

	[A]		[B]		[C]	
	<i>Projected 12/31/05 Without ProForma <u>Operating Expenses and Loan</u></i>		<i>Projected 12/31/05 With ProForma Operating Expenses <u>Without Loan</u></i>		<i>Projected 12/31/05 With ProForma Operating Expenses and <u>Full Amount of Proposed Loan</u></i>	
1 Operating Income	\$	217,863	\$	221,097	\$	221,097
2 Depreciation & Amortization Expense	\$	112,000	\$	215,897	\$	215,897
3 Income Tax Expense	\$	156,280	\$	94,705	\$	81,911
4 Interest Expense on Debt	\$	14,515	\$	14,515	\$	198,123 (a)
5 Repayment of Principal	\$	20,518	\$	20,518	\$	91,398
TIER						
6 [1+3] ÷ [4]		25.78		21.76		1.53
DSC						
7 [1+2+3] ÷ [4+5]		13.88		15.18		1.79
8 Short-term Debt	\$	22,364 (b)	\$	22,364 (b)	\$	93,244 (c)
9 Long-term Debt	\$	193,859	\$	193,859	\$	2,953,979 (d)
10 Equity	\$	1,241,511	\$	1,241,511	\$	1,241,511
11 Total Capital	\$	1,457,733	\$	1,457,733	\$	4,288,733
		100.00%		100.00%		100.00%

(a) The pro forma interest expense was annualized by multiplying the projected balances of existing debt (as of 12/31/05) by their stated interest rates and includes the first year of interest on the entire proposed loan.

(b) Includes \$0 in short-term debt and \$22,364 in projected current maturities on long-term debt as 12/31/05.

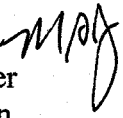
(c) Includes \$22,364 in short-term debt and \$70,880 in current maturities on proposed long-term debt.

(d) Includes \$22,364 in short-term debt and \$2,760,120 in proposed long-term debt.

MEMORANDUM

DATE: October 19, 2005

TO: Crystal Brown
Public Utilities Analyst V
Utilities Division

FROM: Marlin Scott, Jr. 
Utilities Engineer
Utilities Division

RE: Valencia Water Company, Inc.
Docket No. W-01212A-05-0606 (Financing)

Introduction

Valencia Water Company, Inc. ("Company") has submitted a financing application to fund the installation of arsenic treatment systems totaling \$2,831,000 with Water Infrastructure Financing Authority ("WIFA") indebtedness. The Company operates a water system in and around the Town of Buckeye, in Maricopa County.

Existing Water System

According to the Company's 2004 Annual Report, the water system consists of five wells (producing a total of 1,160 gallons per minute), nine storage tanks (totaling 1,320,000 gallons) and a distribution system serving 1,890 service connections. The arsenic concentrations reported from the well sources range from 14 parts per billion ("ppb") to 38 ppb.

Financing Application

The Company is requesting WIFA financing approval in the amount of \$2,831,000 for arsenic treatment systems needed for four current operating well sites and four other well sites that are scheduled to come on-line in February 2006. The eight well sites that require treatment are listed below with their arsenic levels:

<u>Well</u>	<u>Arsenic Level</u>
1. Well ADWR #55-577508 (4 th & Baseline – Large)	28 ppb
2. Well ADWR #55-607657 (4 th & Central)	19 ppb
3. Well ADWR #55-599950 (7 th & Alarcon – Large)	16 ppb

4. Well ADWR #55-202400 (Bales)	14 ppb
5. Well ADWR #55-599204 (Blue Hills)	38 ppb
6. Well ADWR #55-595258 (Sonoran Vista West)	21 ppb
7. Well ADWR #55-595289 (AZ Machinery)	16 ppb
8. Well ADWR #55-203643 (Schult)	18 ppb

Water from five additional future wells will be blended using one treatment system at the Sonoran Vista West well site and water from three other additional future wells will be blended using one treatment system at the Schult well site. As planned the Company will have 16 wells once construction is complete.

The Company plans to install arsenic treatment systems with the financing request as follows:

1.	Design & Engineering – Permits	\$ 101,222
2.	Legal/Debt Authorization	\$ 10,000
3.	Equipment/Materials	\$2,525,492
4.	Construction/Installation/Improvement	\$ 94,312
5.	Contingency	\$ 99,974

Total cost: \$2,831,000

The Company plans to install FlexSorb Modular Sorption Systems as water treatment systems that uses ArsenX media to remove arsenic. ArsenX is a new hybrid arsenic removal media that utilizes nano-particle technology to combine iron chemistry and plastic bead durability. The system supplier will be Mobile Process Technology.

Arsenic Treatment - Alternatives Considered

The Company researched and evaluated four treatment alternatives for arsenic removal; 1) reverse osmosis, 2) ion exchange, 3) adsorbent removal, and 4) coagulation/filtration. Due to restrictions of land size, sewer capacity and waste stream handling, the ion exchange and reverse osmosis treatment methods were rejected. Once the iron-based adsorbent method of treatment was decided upon, further research and field trials were investigated. At the end of the trial runs, the ArsenX media was selected based on its regenerative properties, ease of use and fairly economical capital cost for initial installation.

Pilot Testing

A full scale unit of the FlexSorb Modular Sorption System is scheduled to be installed by October 21, 2005, for further testing and as required by Maricopa County Environmental Services Department ("MCESD").

MCESD Compliance

The MCESD reported no system deficiencies and has determined the water system is currently delivering water that meets water quality standards required by Arizona Administrative Code, Title 18, Chapter 4.

Conclusion

Staff concludes that the arsenic treatment systems totaling \$2,831,000 is appropriate and the cost estimate presented herein is reasonable for purposes of this financing request. However, no "used and useful" determination of the proposed project item was made and no particular treatment should be inferred for rate making or rate base purposes in the future.

Brown

Valencia Water Company, Inc.
3800 N. Central Ave. Ste. 770
Phoenix, AZ 85012
Phone 602-224-0711, Fax 602-224-5455

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AZ CORP COMMISSION
DOCUMENT CONTROL

RE: Docket No. W-01212A-05-0606
Valencia Water Company Finance Application

October 19, 2005

Utilities Division
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

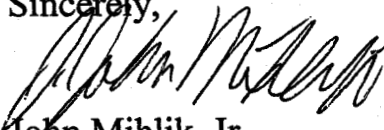
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OCT 19 2005

AZ Corporation Commission
Director of Utilities

To Whom It May Concern:


The attached notice was published on October 18, 2005 in the West Valley View Newspaper that circulates in Valencia Water Company's service area. The Affidavit of Publication from the West Valley View Newspaper is attached.

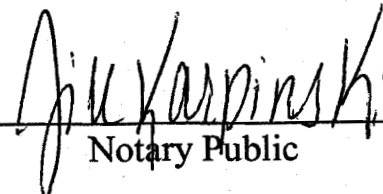
Sincerely,

John Mihlik, Jr.
CFO

Attachment: Copy of Notice and newspaper Affidavit of Publication

STATE OF ARIZONA)
) ss.
COUNTY OF MARICOPA)

SUBSCRIBED AND SWORN before me this 19th day of October, 2005, by John Mihlik, Jr., CFO of Valencia Water Company, Inc.

 **JILL KARPINSKI**
Notary Public - Arizona
Maricopa County
Expires 04/15/09


Notary Public

Docket # W-01212A-05-0606

WEST VALLEY VIEW

200 W. Wigwam Blvd., Litchfield Park, Az. 85340-4636 ♦ (623) 535-VIEW [535-8439]

AFFIDAVIT OF PUBLICATION

State of Arizona

County of Maricopa

I, Elliott Freireich, publisher of West Valley View newspaper of general circulation in Avondale, Buckeye, Goodyear, Litchfield Park and Tolleson, Arizona, attest that the advertisements for

Valencia Water Company, Inc. Ref. Curtis
Goodwin, Sullivan, Udall + Schwab, PLC
Public Notice - Application for an order
Authorizing the issuance of debt.

will be/has been published on October 18, 2005.

Elliott Freireich
Elliott Freireich, Publisher

October 18, 2005.
Date

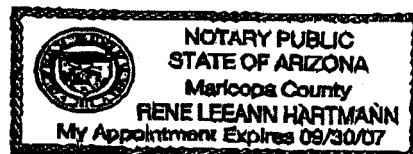
SUBSCRIBED AND SWORN TO BEFORE ME ON THE

18 DAY OF October (Month) 2005 (YEAR)

NOTARY SIGNATURE:

Rene Leeann Hartmann

COPY



Public Notice

AN APPLICATION FOR AN
ORDER
AUTHORIZING THE ISSUANCE
OF DEBT
BY VALENCIA WATER
COMPANY, INC.

Valencia Water Company, Inc. (Applicant) filed an Application with the Arizona Corporation Commission (Commission) for an order authorizing Applicant to issue \$2,831,000 in debt to make improvements to its water system to reduce the arsenic levels. The application is available for inspection during regular business hours at the office of the Commission in Phoenix, Arizona, and the Company's offices in Phoenix and Buckeye, Arizona.

Intervention in the Commission's proceedings on the application shall be permitted to any person entitled by law to intervene and having a direct substantial interest in this matter. Persons desiring to intervene must file a Motion to Intervene and thirteen copies with the Commission's Docket Control at 1200 West Washington, Phoenix, Arizona and serve a copy upon the Applicant c/o William Sullivan, Curtis, Goodwin, Sullivan, Udall & Schwab, P.L.C., 2712 North 7th Street, Phoenix, Arizona 85006. The Motion to Intervene at a minimum, shall contain the following information:

1. The name, address and telephone number of the proposed intervenor and of any person upon whom service of documents is to be made if different than the intervenor.

2. A short statement of the proposed intervenor's interest in the proceeding.

3. Whether the proposed intervenor desires a formal evidentiary hearing on the application and the reasons for such a hearing.

4. A statement certifying that a copy of the Motion to Intervene has been mailed to Applicant.

The granting of Motions to Intervene shall be governed by A.A.C. R14-3-105, except that all Motions to Intervene must be filed on, or before, the 15th day after the date this notice is published.

Published in the West Valley View, and the West Valley Business, on October 18, 2005.